

Introductory Section

Mark Sanford, Chairman
Governor

Grady L. Patterson, Jr.
State Treasurer

Richard Eckstrom
Comptroller General

State Budget and Control Board South Carolina Retirement Systems



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Executive Director

LETTER OF TRANSMITTAL

November 1, 2005

Honorable Mark Sanford, Governor
and
State Budget and Control Board
State of South Carolina

Gentlemen:

We are pleased to present the *Comprehensive Annual Financial Report* (CAFR) of the South Carolina Retirement Systems for the fiscal year ended June 30, 2005. The South Carolina Retirement Systems is required by Section 9-1-300 of the South Carolina Code of Laws to publish annually a report of the fiscal transactions of the system and this CAFR fulfills that statutory requirement. Since the Retirement Systems is a part of the primary government of the state of South Carolina, the Systems' financial information is also included in the comprehensive annual financial report of the State. Responsibility for both the accuracy of the data, and the completeness and reliability of the presentation, including all disclosures, rests with the management of the Systems. To the best of our knowledge and belief, the enclosed data are accurate in all material respects and are reported in a manner designed to present fairly the financial position and results of the Systems.

The CAFR was prepared to conform to the principles of governmental accounting and reporting set forth by the Governmental Accounting Standards Board (GASB). Transactions of the Systems are reported on the accrual basis of accounting. Sufficient internal accounting controls exist to provide reasonable assurance regarding the safekeeping of assets and fair presentation of the financial statements and supporting schedules. The financial statements presented in this CAFR have been independently audited by Rogers & Laban, PA, Certified Public Accountants, under the direction of the State Auditor's Office. Rogers & Laban issued an unqualified opinion, which means that based upon the audit, they concluded that the financial statements were fairly presented in all material aspects and free from material misstatement. Although independent auditors cannot guarantee the accuracy of the statements, they do have a reasonable basis for the opinion they render. The independent auditor's report is presented as the first component of the financial section of this report.

The 2005 CAFR is presented in five sections:

- The **Introductory Section** contains the letter of transmittal, identification of the Systems' administrative organization, and descriptions of administrative responsibilities.
- The **Financial Section** contains the opinion of our independent auditors, Management's Discussion and Analysis (MD&A), basic financial statements and required supplementary information and schedules.
- The **Investment Section** contains schedules of investments and investment growth, a report from the State Treasurer, and a report from our investment consultant.

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- The **Actuarial Section** contains our independent consulting actuary's certification letter, the results of the annual actuarial valuation, a summary of plan provisions for each System, and other actuarial related information.
- The **Statistical Section** contains various tables and schedules of significant data pertaining to the Systems.

Profile of the Systems

The South Carolina Retirement Systems administers four defined benefit pension plans that provide lifetime retirement annuities, disability benefits and death benefits to eligible members. The plans' terms specify the amount of pension benefits to be provided at a future date or after a certain period of time. The amount specified is a function of a formula based on years of service, compensation and age. Our administrative and reporting structure is outlined in the introductory section of this report.

This report contains information on the following defined benefit pension trust funds:

- The South Carolina Retirement System (**SCRS**) was established July 1, 1945, to provide retirement and other benefits for teachers and employees of the state and its political subdivisions.
- The Police Officers Retirement System (**PORS**) was established July 1, 1962 to provide retirement and other benefits to police officers and firefighters.
- The Retirement System for Members of the General Assembly of the State of South Carolina (**GARS**) was established January 1, 1966, to provide retirement and other benefits to members of the General Assembly.
- The Retirement System for Judges and Solicitors of the State of South Carolina (**JSRS**) was established July 1, 1979, to provide retirement and other benefits to state Judges and Solicitors.

Fiscal Year 2005 Highlights

Fiscal year 2005 was both an active and challenging year for the South Carolina Retirement Systems. While the Retirement Systems experienced a higher workload trend for the fourth consecutive year, the South Carolina General Assembly formed two ad hoc retirement committees to study the funding status of SCRS and draft legislation to secure its fiscal integrity and protect cost-of-living adjustments (COLAs) for SCRS retirees.

Judges and Solicitors Retirement System Changes Enacted

Other major activity for the fiscal year included legislation enacted effective July 1, 2004, to improve the solvency of the Retirement System for Judges and Solicitors (JSRS). The significant changes to JSRS included the incremental increase (for three consecutive years) of the rate at which employees contribute to the system, the imposition of certain restrictions on service purchases and increase of such costs to coincide with the employee contribution rate, and the lengthening of vesting periods and eligibility for deferred annuities.

Identify Theft Prevention Measures Undertaken

Several projects were initiated to strengthen identity theft controls. Information was disseminated to all annuitant payees receiving monthly checks to encourage them to convert to electronic deposit. This initiative resulted in an increase in the percentage of payees receiving benefits via direct deposit from 79 percent to 85 percent. In addition, another division-wide identity theft project was completed to mask social security numbers on correspondence to our membership.

Expanded Employer Reporting Requirements

For fiscal year 2005, the Retirement Systems implemented expanded employer reporting requirements for the State Optional Retirement Program (State ORP) and began capturing detailed quarterly earnable compensation data for individual participants. State ORP is a defined contribution plan that is administered by the South Carolina Retirement Systems that serves as an alternative to SCRS, the traditional defined benefit plan.

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Employees hired into positions with state agencies, institutions of higher education, and public school districts may elect within 30 days of their date of hire to participate in State ORP.

Pre-Tax Installment Service Purchase Program Implemented

The Retirement Systems' program through which members are allowed to purchase various types of service credit via an installment service purchase was expanded effective January 1, 2005, to allow tax deferred installments. Current participants were given a one-time opportunity to convert the remaining balances of existing after-tax accounts to a tax deferred account. This expanded feature provided an opportunity for our membership to achieve a substantial income tax savings.

Press Seminar Conducted

In early January 2005 in anticipation of an active legislative session, the Retirement Systems sponsored a seminar for members of the print media who report on retirement issues. The seminar familiarized the reporters with the basics of public pension fund administration, and provided a primer on unfunded actuarial accrued liability (UAAL) and other fundamentals of actuarial science.

State Retirement System Preservation and Investment Reform Act

Retirement Systems staff coordinated the preparation and dissemination of voluminous actuarial and other information for the two ad hoc retirement committees formed by the South Carolina General Assembly during its 2005 session.

The South Carolina House of Representatives and the South Carolina Senate introduced separate legislation with different approaches to securing the funding of SCRS and protecting retired member COLAs. Following action by a conference committee appointed to reach an agreement, the General Assembly passed Act 153, the State Retirement System Preservation and Investment Reform Act, effective July 1, 2005.

This sweeping legislation required retired members of SCRS and PORS who either participate in the Teacher and Employee Retention Incentive program or return to covered employment to make employee contributions to the system. Active TERI participants and working retirees who retired and returned to work prior to July 1, 2005, have challenged the requirement that they pay member contributions. For further details, see Note VIII on page 43.

Act 153 also increased the SCRS employee contribution from 6 percent to 6.25 percent effective July 1, 2005. The SCRS member contribution will increase to 6.5 percent as of July 1, 2006. Employer contributions will increase as well from 7.55 percent to 8.05 percent effective July 1, 2006, and to 8.55 percent as of July 1, 2007.

Furthermore, the legislation guaranteed and pre-funded a COLA for eligible SCRS retirees. If the Consumer Price Index (CPI) increases no more than 1 percent, the COLA is equal to the percentage increase in the index. If the CPI increases by more than 1 percent, the South Carolina Budget and Control Board is authorized to approve an additional COLA beyond the 1 percent up to the lesser of the CPI or 4 percent. Legislation also requires that funding requirements have been met including all unrealized investment gains and losses.

In addition, Act 153 established a six-member investment commission made up of financial experts, the State Treasurer and a nonvoting retired member, and moves fiduciary responsibility for all investments to the commission; provided that equity investments cannot exceed 70 percent of the total investment portfolio (formerly 40 percent); and created the position of chief investment officer. This part of Act 153 was effective October 1, 2005.

Local Government Employer Contribution Rate Increase

An increase in the rate at which local governmental entities contribute as an employer to SCRS was approved. The employer contribution will increase from 6.5 percent to 7.55 percent effective July 1, 2005.

Teacher and Employee Retention Incentive Program Remained Popular

The deferred retirement option program, Teacher and Employee Retention Incentive (TERI), which was initiated January 1, 2001, continued to experience great popularity among our membership during fiscal year 2005. The amount of assets held in trust for future payments of accrued benefit expense increased from \$649 million to \$884.5 million during the fiscal year. This increase is a result of both a growth in new participants in the program during the fiscal year and the continued accumulation of benefits deferred on a monthly basis for all participants.

For the past three fiscal years, legislation has been proposed in the South Carolina General Assembly to repeal the TERI program; however, no action was taken on the bills. TERI continues to be a very controversial issue and threat of possible repeal again contributed to the large number of new participants taking advantage of TERI. Act 153, referred to earlier, did exempt all TERI participants from state grievance rights and required them to make employee contributions to the system.

Active Membership Decreased

Although the number of active members contributing to the South Carolina Retirement Systems decreased for the past two fiscal years, the actual workforce of covered employers throughout the state grew slightly. This resulted from increased State ORP participation and an increased number of working retirees who are either participating in the TERI program or who have terminated employment and returned to work under the earnings limitation.

During fiscal year 2005, a retired member of SCRS who has been retired for at least 60 days could return to employment covered under the system and earn up to \$50,000 a fiscal year without affecting the monthly retirement benefit. Under PORS, a member who has been retired for at least 15 consecutive calendar days may be hired and return to covered employment without affecting the monthly retirement benefit. Act 153 made changes to the earnings limitation for working SCRS retirees to be consistent with PORS retirement provisions.

Number of Annuitants on Payroll Exceeds 100,000

The number of retired members and beneficiaries receiving monthly benefits under the Retirement System plans exceeded 100,000 annuitants during the year.

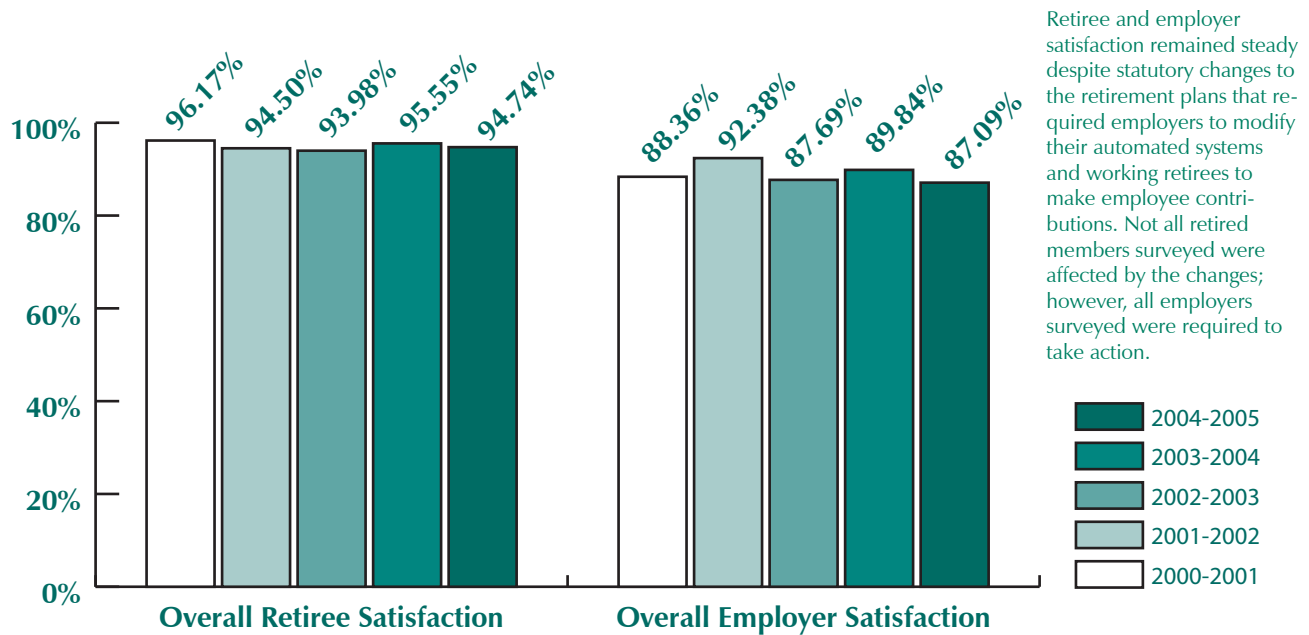
Rankings Among Peer Pension Plans

The South Carolina Retirement Systems is one of the public pension plans that participates in an annual benchmarking analysis conducted by Cost Effectiveness Management, Inc., (CEM). Fifty-four public pension plans participated in the 2004 CEM survey.

Although the Retirement Systems is a customer centric organization, we are also a division of South Carolina state government and as such, must adhere to stringent budgetary guidelines. According to the CEM report, the South Carolina Retirement Systems' total adjusted administrative cost per member was \$46 in comparison to a peer median cost of \$67, the fifth lowest cost among all 54 participants.

Our low administrative cost is achieved through the efficient and proactive deployment of automated systems and appropriately allocated human resources, not by providing fewer or lower quality services. The CEM report is evidentiary of this claim. Our total service score was 75 in comparison to averages of 73 for our peer systems and for all participants. Our 2004 service score of 75 was up from 66 in 2003 and 69 in 2002. In addition, our own annual satisfaction surveys continue to show that our customers are pleased with the services we provide (see chart at top of Page 11).

South Carolina Retirement Systems Customer Satisfaction Ratings



Summary of Financial Condition

The funding objective of the pension trust funds is to meet future benefit obligations of retirees and beneficiaries through contributions and investment earnings. Our external consulting actuaries determine the actuarial accrued liability of the Systems. In our most recent valuations dated July 1, 2004, our actuarial consultants concluded that the Systems are operating on an actuarially sound basis. Governmental accounting standards require that the maximum acceptable amortization period for the total unfunded actuarial liability is 30 years and all four systems are considered adequately funded within GASB standards. The funded ratio for the SCRS, which represents the largest membership of the four plans, decreased from 82.8 percent to 80.3 percent, primarily due to a 1.6 percent cost-of-living adjustment effective as of July 1, 2004, and other experience losses. As a result of these and other factors, the amortization period for the System's unfunded actuarial accrued liability increased from 25 to 27 years. The current funded ratios of the four plans range from 60.5 percent to 87.7 percent. More detailed information regarding the financial condition of the pension trust funds can be found in the financial and actuarial sections of this report.

For the year ended June 30, 2005, the combined Systems investment portfolio produced a total aggregate investment return of 7.02 percent. Asset allocation of our equity investments, including interest and dividend accruals and categories classified as cash and cash equivalents, are summarized in the table below (dollar amounts expressed in millions):

	<u>Growth</u>	<u>Core</u>	<u>Value</u>	<u>Total Active</u>	<u>Passive</u>	<u>Total</u>
Large Cap	\$ 1,425.0	\$ 989.5	\$ 969.3	\$ 3,383.8	\$ 5,512.7	\$ 8,896.5
Small/Mid Cap	792.1	622.0	838.4	2,252.5	-	2,252.5
Total	<u>\$ 2,217.1</u>	<u>\$ 1,611.5</u>	<u>\$ 1,807.7</u>	<u>\$ 5,636.3</u>	<u>\$ 5,512.7</u>	<u>\$ 11,149.0</u>

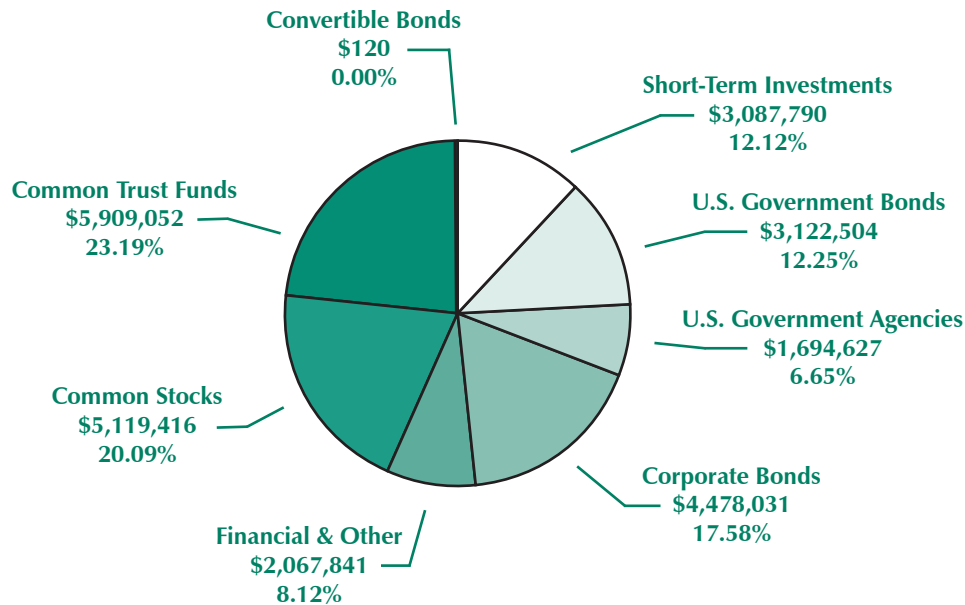
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An optimally diversified investment portfolio is designed to provide long-term returns. While our investment performance has been limited by our state constitution and state statute, the custodian of our assets, the State Treasurer, and the Investment Panel work diligently to ensure our investment strategy is pragmatic and conservative, while providing competitive returns. The total asset allocation of investments is presented in the following graph:

South Carolina Retirement Systems Schedule of Asset Allocation

Market Value as of June 30, 2005

(Dollar amounts expressed in thousands)



Investment performance is a significant factor in our actuarial valuations. Our actuarial consultants use an actuarial asset valuation method that recognizes a portion of the difference between the actual market value of assets and the expected actuarial value of assets, based on the assumed investment rate of return of 7.25 percent. This method recognizes 20 percent of the difference between market and expected actuarial value each year and guarantees that any gain or loss is recognized over a five-year period. The actuarial value of assets is limited to a range between 80 percent and 120 percent of market value. This actuarial asset valuation method dampens year-to-year fluctuations, smoothes the effect of volatility in the market and helps provide a consistent estimate of the value of assets. Detailed investment results for fiscal year 2005 can be found within both the financial and investment sections of this report.

For additional financial information, please refer to the management's discussion and analysis, financial statements and schedules included in the financial section of this report.

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the South Carolina Retirement Systems for its *Comprehensive Annual Financial Report* (CAFR) for the fiscal year ended June 30, 2004. The Certificate of Achievement is a prestigious national award recognizing excellence in the preparation of state and local government financial reports.

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In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, the contents of which meet or exceed program standards. The CAFR must satisfy both generally accepted accounting principles and applicable legal requirements. A Certificate of Achievement is valid only for a period of one year. The Systems has received a Certificate of Achievement for each of the last 18 consecutive years (fiscal years ended 1987-2004). We believe our current report continues to conform to the Certificate of Achievement Program requirements, and we are submitting it to the GFOA for consideration again this year.

Public Pension Standards Award

The South Carolina Retirement Systems also received the Public Pension Coordinating Council's Public Pension Standards 2005 Award. It is the second consecutive year during which the Retirement Systems applied for and received the Council's award in recognition of meeting professional plan design and administration standards. The Public Pension Coordinating Council is a confederation of the National Association of State Retirement Administrators, the National Conference on Public Employee Retirement Systems, and the National Council on Teacher Retirement.

Acknowledgments

The compilation of this report reflects the combined efforts of the staff of the South Carolina Retirement Systems functioning under your leadership. The report is intended to provide comprehensive and reliable information about the Systems, to demonstrate compliance with legal provisions, and to allow for the evaluation of responsible stewardship of the funds of the Systems.

We express our gratitude to the members of the Board, the staff, the consultants, and the many people who have worked so diligently to assure the continued successful operation of the Systems.

Respectfully submitted,



Peggy G. Boykin, CPA
Director



Tammy B. Davis, CPA
Assistant Director, Financial Services





Governing Board and Administration

Governing Board - SC State Budget and Control Board

Mark Sanford, Chairman	Governor
Grady L. Patterson, Jr.	State Treasurer
Richard Eckstrom	Comptroller General
Hugh K. Leatherman, Sr.	Chairman, Senate Finance Committee
Daniel T. Cooper	Chairman, House Ways and Means Committee
Frank W. Fusco	Executive Director

Equity Investment Panel¹

Peter Bristow	Chairman
Arthur M. Bjontegard, Jr.	
Blaine Ewing, III	
Mary M. Kennemur	
S. Hunter Howard	

Retirement System Investment Commission²

Reynolds Williams	Chairman
Grady L. Patterson, Jr.	State Treasurer
Blaine Ewing, III	
James R. Powers	
Allen R. Gillespie, CFA	
Nancy E. Shealy	Administrative Director and General Counsel

Equity Investment Consultant

Mercer Investment Consulting, Inc.

Consulting Actuary

Milliman Consultants and Actuaries

Retirement Systems Executive Management

Peggy G. Boykin, CPA	Director
Dianne T. Poston	Assistant Director – Administration
Alice R. Copeland	Assistant Director – Customer Services
Tammy B. Davis, CPA	Assistant Director – Financial Services
Lisa Phipps	Assistant Director – Information Technology
Amanda J. Green	Assistant Director – Service/Imaging
Stephen R. Van Camp	General Counsel – Retirement Systems
Nancy E. Shealy	General Counsel – Investment Panel
Sarah N. Corbett, CPA	Internal Auditor

Retirement Systems Staff Responsible for Compilation of CAFR

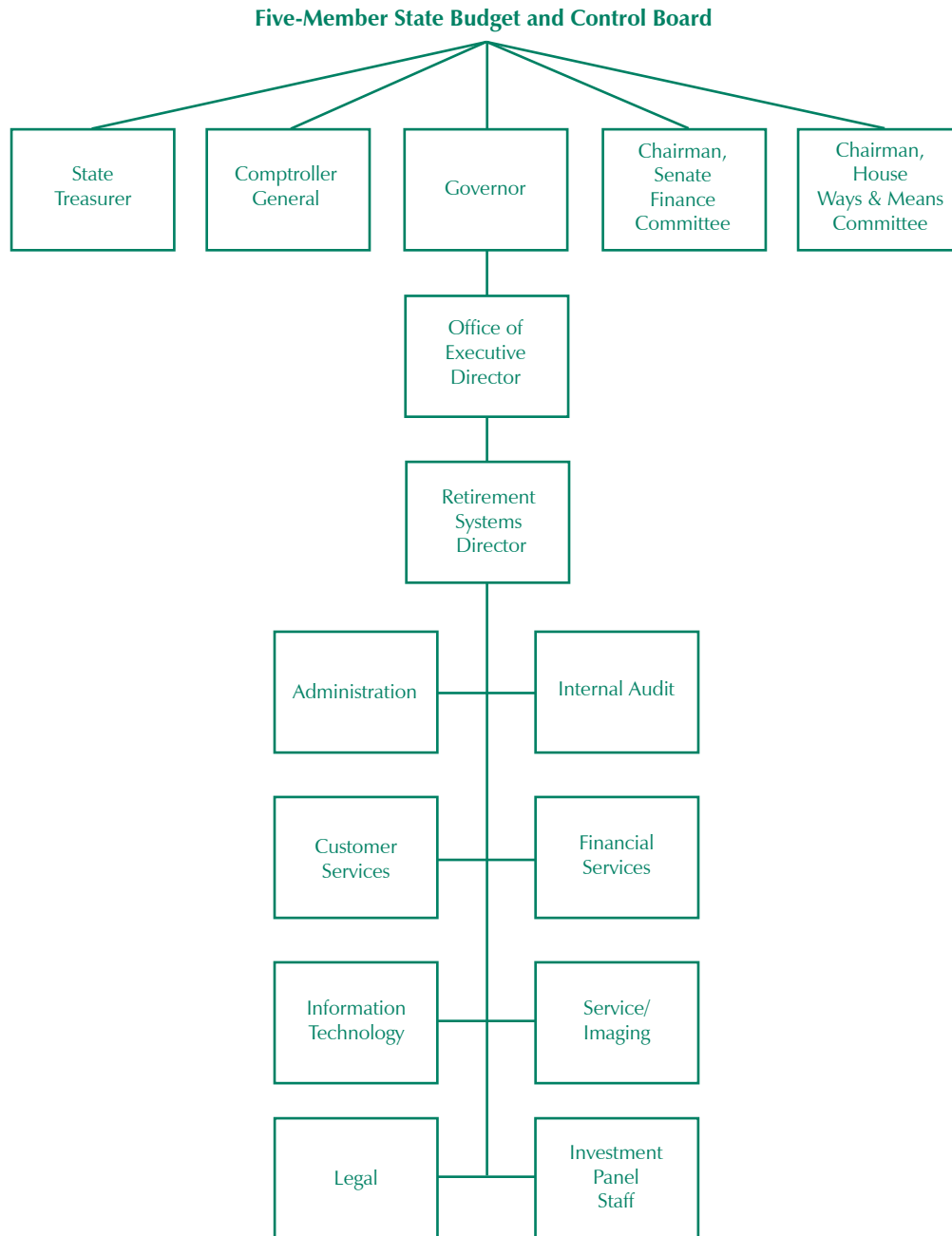
Travis Turner, CPA	Financial Services
Ashley Nichols, CPA	Financial Services
Faith Wright	Financial Services
Megan Reynolds	Public Information Officer

¹Refer to page 73 for a complete list of equity managers.

²Created by law effective October 1, 2005. See page 9 for more information.

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Organizational Chart



Organizational Description

The structural organization of the Systems is depicted in the organizational chart on page 13. A brief description of the primary functions performed by each department follows:

Internal Audit

Responsible for providing an independent appraisal function to examine and evaluate processes and policies, and for providing assurance to management regarding the internal control structure of the division.

Legal

Responsible for representing the South Carolina Retirement Systems in matters before circuit and appellate courts and administrative bodies, and for providing program support to the management of the South Carolina Retirement Systems.

Administration

Responsible for managerial, budgetary, and administrative oversight of all division operations; physical plant issues, operations, and maintenance; procurement; human resources activities; communications and public information; accounts payable; postal center operations and courier services; and the State Optional Retirement Program.

Customer Services

Responsible for member consultations (in person, by telephone, on-line via the Internet, or by videoconferencing) in all phases of retirement operations; the processing of customer claims relating to annuities, refunds, or death claims; training employers in all aspects of the Retirement Systems' member benefits, reporting procedures, and the Internet accessed employer information system; briefing governing bodies of prospective new employers on member benefits and new employer liability regarding potential costs associated with joining the Retirement Systems; meeting with employees as requested to present benefit overviews and preretirement education programs; and coordinating and conducting retirement seminars designed to better prepare members whose retirement is imminent.

Financial Services

Responsible for all financial reporting and accounting including the preparation of the Comprehensive Annual Financial Report; disbursing monthly payments to annuitants, refunds to terminated members and death benefit payments to eligible members; determining the average final compensation to be used in calculating a member's annuity benefit at retirement; collecting and allocating member and employer contributions; and maintaining membership enrollment and beneficiary information.

Information Technology

Responsible for the design, implementation and control of all automated applications within the Systems.

Service Credit and Imaging Services

Responsible for the computation of the cost for purchases of prior service for all members of the Retirement Systems; the auditing of service credit for our membership; and the maintenance of complete historical records of each member.

Investment Panel Staff

Responsible for providing legal, research, and administrative support to the State Retirement Systems Investment Panel, and to the South Carolina Retirement Systems and the State Budget and Control Board on issues relating to the Retirement Systems' equity investments.